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The 2013 Geopolitical Outlook

As is our custom, in mid-December, we publish our geopolitical outlook for the coming year. This list is not designed to be exhaustive. As is often the case, a myriad of potential problems in the world could become issues in the coming year. The lineup listed below details, in our opinion, the issues most likely to have the greatest impact on the world. However, we do recognize the potential for surprises which we will discuss throughout the year in the weekly reports. This will be our last report for 2012; our next report will be published on January 14, 2013. And so, we wish all our readers happy holidays and a joyous 2013.

Issue #1: The Continued Evolution of U.S. Hegemony

This particular issue has topped our list several times in our year-end and mid-year outlooks. It is a major theme in our analysis of current global geopolitics. To recap, the U.S. shared global dominance with the Soviet Union from 1945 to 1990. In this period of the Cold War, the U.S. led the Free World while the Soviets controlled the communist bloc. With the collapse of the Soviet Union, the U.S. was unexpectedly thrust into global domination. This situation was profiled by two academics, Francis Fukuyama and Sam Huntington. The former argued that the West won and with the fall of communism there was no alternative to governance and economic development save democracy and

capitalism. Huntington had a more pessimistic view, suggesting that the Cold War had put an artificial restraint on other conflicts. These "frozen conflicts" were mostly tied to religion, culture and tribal relations. These situations were usually long-standing issues that had been put aside during the epic conflict between the Soviet Union and the U.S. However, with the end of the Cold War, in Huntington's opinion, the global hegemon would be faced with managing these conflicts as they emerged from the artificial constraint of the earlier superpower conflict.

Since the Cold War ended, the U.S. has struggled to manage the superpower role. For most of the 1990s, the U.S. behaved as if the fall of the Soviet Union was the supreme victory, and because of that win the U.S. deserved a "peace dividend." In this period, the U.S. economy prospered, American equity markets enjoyed the second decade of a secular bull market and defense spending relative to the size of the economy declined.

As the 1990s came to a close, however, issues emerged. First, Saddam Hussein, who had been defeated in the First Gulf War, remained in power. Sanctions had clearly weakened his grip but isolation did not cause his government to fall. Second, the breakup of Yugoslavia was being poorly managed by the EU and required U.S. intervention. Given that the turmoil was not a direct strategic issue for the U.S. (but was for Europe), the need for American intervention was an indication of broadening U.S. obligations.

Third, the U.S. success in the First Gulf War and in Kosovo signaled to the rest of the world that engaging the U.S. in a conventional military sense was foolhardy. That didn't mean the U.S. was invulnerable but that unconventional actions were the most cost-effective way to attack America. In other words, insurgent activities and terrorism were the best ways to attack the U.S. As the rise of al Qaeda and the attack on 9/11 showed, these unconventional measures could be successful against a superpower.

The reaction of the Bush administration was to lash out at the terrorist and insurgent threat with a series of military interventions while, on the domestic front, maintaining the post-Cold War victory stance. In other words, instead of putting the country on a war footing, as it had been for much of the period from 1945 to 1990, Bush fought major wars in Afghanistan and Iraq, replete with mission creep. Although U.S. forces were able, with relative ease, to oust the governments in Afghanistan and Iraq, managing the nation-building that has been required after overthrowing the Taliban and the Hussein regime has been a major problem.

In the aftermath of the last decade's wars, the Obama administration has been gradually developing a new foreign policy. It is fairly obvious that the development of Obama's foreign policy has been a work in progress. But he should get credit for learning over time. Early in his first term he tried to make nice with Europe, Russia and the Middle East, especially Iran. His reward was to be ignored by Europe (other than getting a Nobel Peace Prize prematurely), snubbed by the Russians and disregarded by the Middle East, both allies and enemies alike. In fairly short order, his policies began to evolve.

What we are seeing develop could be graciously described as "offshore rebalancing" or harshly portrayed as "neo-isolationism." Essentially, the president is trying to build a foreign policy for a superpower that is facing growing budget constraints and groaning under the costs of global leadership. Being the global superpower brings benefits; there is something fetching about being the "indispensable nation" as President Clinton described the U.S., and being the reserve currency allows the American economy to run persistent trade deficits without serious foreign exchange problems. However, this role allows other nations to "free ride" U.S. military power, and the reserve currency status forces higher levels of consumption than reasonable. It also opens the U.S. economy to debilitating foreign competition that it must maintain as a level of economic power.

To a great extent, America's excessive leverage problem is a direct result of being a superpower. There is a strong case to be made that the costs of global hegemony exceed the benefits, at least for many Americans. However, the costs of abandoning global leadership are high as well. The political leaders after WWII accepted this role because the alternative, either another world war or communist domination, was considered unacceptable. If the U.S. abandoned this role today, the world would suffer greatly from this decision. At some point, the U.S. probably would regret the decision as well.

Thus, President Obama is trying to weave a new policy that allows the U.S. to continue its outsized influence at significantly lower costs. This means that the U.S. more judiciously allocates its influence into regions that are of strategic importance and allows other areas to be dominated by

regional hegemony or balanced between two or more powers, with the U.S. holding the balance of power between the competing states.

In theory, this is an elegant solution to the U.S. problem. It avoids the dangers of full isolation and the costs of Wilsonian global commitments. However, in practice, it is hard to do. Countries around the world have become accustomed to American protection and have allowed their militaries to atrophy. It is hard to discern what area is of strategic importance and which is not. In a democracy like the United States which was populated by immigrants, there is always some pressure group pining to use American power to settle a frozen conflict in the “old country.”

As the U.S. embarks on this policy change, the world is going to be reshaped in numerous ways. The rest of this report discusses the various ramifications of this policy evolution.

Issue #2: The Rearming of the Axis

In the aftermath of WWII, the U.S. decided that it would provide military security for Germany and Japan. There were two reasons for this decision. First, the U.S. didn't want these nations to rearm so as to replay WWII all over again. Second, America wanted these two nations to focus on economic rebuilding to prevent them from falling into the clutches of the communists. Investment funds were directed toward rebuilding the economy and not the military in Japan and Germany.

For the most part this plan worked. Japan and Germany became reliable allies for the U.S. and strong members of the Western alliance. The U.S. military established large bases in both nations that allowed for power

projection toward mainland China and the U.S.S.R.

As the Cold War progressed, both Germany and Japan's economies not only recovered but became significant global economic powers. The benefits of avoiding military spending allowed both nations to create economies with either broad social safety nets or high employment.

In the new American foreign policy that is emerging, the U.S. will likely encourage Japan and Germany to rearm and take their roles as regional powers. In Europe, it is clear that Germany is a financial and economic hegemon. *The U.S. wants Germany to expand that role to ensure that the Eurozone does not cause a global financial crisis, even if those policies are not necessarily in the interests of the German people.* Germany has less need to rebuild its military given the relative peace that has developed in light of the demilitarization of Europe. However, it would not be a shock to see the German military rebuilt over time.

For the rest of Europe, the signal coming from the U.S. is clear—live under German financial and economic hegemony or face an uncertain future outside the Eurozone. The U.S. has avoided direct financial involvement in Europe and will probably continue this policy. This means that Eurozone integration will occasionally generate financial crises. These events, though frightening, are necessary to force politicians to accept German domination.

In Japan, the U.S. is actively supporting Japanese rearmament. Japan has a rather formidable navy already and could become a major factor in balancing China's rapid rise. We note that the *Financial Times* reported on December 10th that the Philippines would

support a move by Japan to end its post-WWII constitutional ban on offensive military activities. As the Asian nations become increasingly concerned about China and worried the U.S. won't be able to defend them, they are moving to create their own ways to contain Chinese power. The thought that any Asian nation would support the rise of Japan's military is stunning in light of Japanese atrocities during WWII. However, there is probably no other nation in the region capable of acting as a check on Chinese power. We would expect these nations to prefer U.S. hegemony, but if that isn't possible then creating other security arrangements becomes imperative.

Issue #3: The Arab Spring Develops Unabated

The Arab Spring continues to work its way through the Middle East. As we noted last week, in Egypt, the military and the Muslim Brotherhood continue to define their relationship. Syria remains in civil war. The Kurds appear closer to autonomy if not an independent state. If the Kurds break away, Iraq will probably split between Sunnis and Shiites. Protests are rising in Jordan and Bahrain. Turkey is becoming increasingly Islamist.

The true legacy of the Arab Spring may turn out to be the more natural drawing of borders in the region. Most of the borders in the Middle East were drawn by British and French diplomats; they were carved in such a way as to create manageable states for European imperialists. The Syrian civil war could easily result in the breakup of the country, and once this process starts it may become impossible to control.

Thus far, the U.S. appears willing to let the process continue with minimal interference. The U.S. "led from behind" in the ouster of

Qaddafi in Libya and did not intervene in Mubarak's fall in Egypt. Although there has been great concern about a military strike on Iran to prevent the country from developing nuclear weapons, thus far, the U.S. has been content to address the issue with sanctions, cyberattacks and covert activity. In the end, this might not stop Iran from gaining a weapon but it appears that, despite the rhetoric from the administration, the U.S. will not use military action to stop Iran from getting a bomb.

The same situation may be developing in Syria. The U.S. does not want to see Assad regain control, but isn't supportive of much of the opposition due to ties to Islamic terrorism. In fact, continued conflict might be the best outcome for the U.S. as it will force Iran to support the failing Assad. Although the U.S. could live with the breakup of Syria, it has little interest in forcing the issue. Thus, the civil war in Syria probably continues unabated in 2013.

Essentially, the U.S. appears to be allowing the development of multiple powers in the Middle East. One would expect the U.S. to balance these powers by strategically supporting one or the other based on how conditions develop. The development of North American energy assets allows the U.S. to effectively lower the importance of the Middle East.

Issue #4: The Problem of China

By reducing American involvement in Europe and the Middle East, the U.S. can shift its focus elsewhere. That "elsewhere" has become a pivot to Asia.

China sees this shift as an attempt to curtail its rise as a global power. Although the U.S. protests otherwise, in fact, China is probably right on this aim. How an established

superpower deals with a rising power is always delicate. Britain's inability to cope with the rise of Germany led to two world wars. The U.S. had to cope with the Soviet Union, a process that took 45 years to resolve.

America's task of dealing with an ascendant China is difficult. China's economic development has been a major global success story as millions have emerged from poverty. For the most part, Deng Xiaoping's plan of restructuring was mostly isolationist. He instructed Chinese leaders to engage in a "peaceful rise." However, China's economy has become large enough that it needs to integrate its foreign policy into its economic development. China is heavily dependent upon natural resources and the security of supply for these goods is dependent upon the U.S. Navy. This situation is worrisome for Chinese leaders.

In addition, China has rather extravagant claims for the China Sea, claiming control of nearly all of that body of water. The rest of the world does not take such claims seriously and it isn't obvious that China really believes its own rhetoric. However, Chinese officials will tend to use these maritime claims to drum up nationalist sentiment. The risk is that the leadership may not always be able to control this sentiment which may lead to conflict.

Although the U.S. is engaged in a pivot toward Asia, we do not expect American domination. Instead, we would look for the U.S. to play the "over the horizon" power that attempts to balance China's rise. This will mean allowing other nations in the region to shoulder a greater burden. Specifically, as noted above, Japan will likely take on a significant military role in the Far East, a major change from its position since the end of WWII.

At the same time, there is a risk that the Chinese economy could implode. China's economic model is based on investment and export promotion. This model was used successfully by Japan until the early 1990s, when its inability to shift to a consumption model led to a two-decade economic debacle. China obviously wants to avoid a similar fate but the Chinese Communist Party (CPC) leadership, to shift to a consumption-based economy, must overcome significant interests within the party that have become wealthy under the current model. If this change cannot be delivered, the greater risk from China could be an economic downturn of serious magnitude.

The U.S. needs to create conditions that will help China avoid an economic disaster while also ensuring that its rise doesn't become a threat to regional peace. This outcome will be difficult to engineer and will test the political and diplomatic skills in the U.S. and other Asian nations.

Issue #5: The Great Game between China and Russia

In the 19th century, the British and Russian empires were engaged in a strategic rivalry for control of Central Asia. This rivalry consisted of a series of conflicts in present day Afghanistan, Mongolia, China and Tibet.

At present, we are watching Russia attempt to re-establish control in its "near abroad" which includes the "Stans" and Georgia. These regions, previously part of the Soviet Union, became independent after the Cold War ended. Russian geopolitics is cyclical. The land surrounding the core of Russia offers few natural defenses. To protect this core, throughout history Russia has invaded

the area surrounding its core. This forces invaders to stretch supply lines, increasing the danger of attack. Both Napoleon and Hitler failed to overcome the Russian winter and the distances required in attacking the Russian core.

However, holding this territory is problematic. Colonization is usually expensive and the local populations tend to oppose Russian dominance. Thus, in other periods, Russia, unable to hold its near abroad, sees its country shrink. This devolution makes the Russian core more economically viable but also makes it vulnerable to invasion.

The collapse of the Soviet Union was the most recent iteration of this process. Over the last decade, the Russian economy has enjoyed a strong recovery on the back of high commodity prices. As if on cue, the Putin government is trying to extend its influence back into the Russian near abroad.

However, in this instance, the next Great Game isn't between the British and the Russians but the Chinese and the Russians. Central Asia, with ample natural resources, is an attractive area for China. For China, these are resources that are free of U.S. Navy influence. Chinese investment in this region, including oil and gas exploration, mining, and transportation infrastructure, offers the "Stans" an alternative to Russian domination. Although the U.S. is nominally involved in the area, once the Afghan War

ends, we expect U.S. influence to wane. Central Asia will become the prime area for strategic expansion for both China and Russia. We doubt this will become a hot war but would expect the region to become increasingly unstable as these two nations compete for influence.

Ramifications

The underlying geopolitical theme is the continued evolution of U.S. superpower policy. We assume the Obama administration is trying to redefine this role. Although this is probably a necessary change, getting it right will be extremely difficult. As the U.S. retreats from certain areas, vacuums will develop that will be filled by regional hegemons. The U.S. will still have the power to contain these regional powers from expanding, but within their spheres of influence they will generally be in power. The world simply isn't used to this condition and thus the potential for unexpected outcomes is rising.

From an investing perspective, the steady withdrawal of the U.S. from the world will tend to make regions less stable. We continue to recommend investors hold strategic positions in hard assets as a way to protect portfolios from such events, and maintain an equity exposure that favors dividend paying securities in higher volatility markets.

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